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ON THE VERGE OF 1992: JAPAN AND THE EUROPEAN COMMUNITY

Summary

The 12 nations of the European Community are less than a year away from the start of a plan to more completely integrate their economies into a true common market covering all goods and services. Such a momentous change naturally is having a broad impact not only within Europe but externally as well, as can be seen in the EC's shifting relations with its major trading partners. Both Tokyo and major Japanese companies face many uncertainties in trying to adapt to Europe 1992, since the EC has not yet drawn up all the rules for the new economic union.

Background

After a fashion, the postwar development of Japan and the 12 nations that now make up the European Community* followed many parallel paths. Both depended on the United States for military security, including coverage by the American nuclear umbrella: the EC via the North Atlantic Treaty Organization; Japan under the aegis of the U.S.-Japan Mutual Security Treaty. The United States also played a large role in the economic life of the EC and Japan, both as a source of capital and technology and as a supplier and a buyer of goods. Conversely, the level of economic interdependence between the EC and Japan was very low; bilateral security relations were almost nonexistent. As a result, postwar Japan-EC relations have been stunted, overshadowed by the economic and political dominance enjoyed, until recently, by the United States.

*Member countries of the European Community are: Belgium, France, Italy, Denmark, Greece, Luxembourg, the Netherlands, Ireland, Portugal, Spain, Germany and the United Kingdom.

This uneven tripartite relationship is now in flux. New parallels between Japan and the EC are emerging. In terms of relative economic size the United States no longer is head and shoulders above the other two. Japan's total output of goods and services is about two-thirds that of the United States; moreover, its economy consistently has exhibited a much higher rate of real growth. When the EC's 1992 plan is activated fully, the community's population and economic output will be greater than that of the United States by about one-third and one-quarter, respectively. In specific markets Japanese and European manufacturers now lead the United States, and international competition among the three is growing ever more intense.

In the military area the Persian Gulf crisis not only underscored the continuing international leadership position of the United States but, perhaps more significantly, suggested a new era of allied cooperation on security issues around the world (even if, as in Japan's case, such support does not involve personnel or equipment). Greater allied cooperation on world security matters was a central element of Washington's international strategic plan even before Iraq invaded Kuwait; for example, Japan's self-defense forces are a cornerstone of the U.S. strategy for Northeast Asian security. But Operations Desert Shield and Desert Storm demonstrated that a multinational approach to global security problems can work.

The economic and military convergence of the EC and Japan with the United States have drawn both Brussels and Tokyo closer to the center of action in global affairs. Whether either is up to the challenge, however, remains an open question. The Iraq-Kuwait war showed that EC members individually could launch diplomatic initiatives apart from the United States, but that collective action as the European Community still was lacking. Similarly, Japan's performance under stress has raised questions about its qualifications for global political leadership. Economically, too, the two face fresh challenges commensurate with their new influence. The reason the current Uruguay Round of multilateral trade negotiations is stalled, from Washington's standpoint, is the failure of both the EC and the Japanese governments to resist parochial pressures and act in the interests of the entire global economy.

With both the EC and Japan groping for their new places in global affairs, it is not surprising that bilateral ties are changing. Making the situation more volatile is the pending action on the many important details necessary for implementing the EC's 1992 plan -- details equally important to EC members and their trading partners. As the two actors step away from their supporting roles and into the spotlights, they must deal with a long list of long-standing bilateral issues as well as with new issues raised by their reemergence as major powers in global affairs.

Past Frictions

Trade, in a word, sums up the issues that have hampered smooth EC-Japan relations during much of the postwar era. Aggregate trade flows as well as disputes over specific products have generated friction. From an overall trade standpoint the EC-Japan dialogue often echoes the U.S.-Japan relationship. Just

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as it does with the United States, Japan runs a sizable trade surplus with the EC as a whole. Similar to the response by Washington, Brussels and individual member governments have harangued Tokyo to lift tariff and nontariff barriers and to curb "unfair" trade practices, whether instituted by the government or by Japanese companies. Trade statistics highlight the EC's cause for concern but also portend an improvement.

Trade Balances - Tables 1 and 2 chronicle Japan's trade with the EC and with selected EC members in both dollar and yen terms. The expansion of Japan's surplus with the EC in the mid-1980s truly was spectacular when viewed in dollars: 50 percent in 1986 and 20 percent the following year. Hardly causing comment, however, is the trade balance denominated in yen. The surging growth of imports (from the EC as a whole and from most members individually) in the 1988-90 period and the corresponding decline in Japan's surplus (viewed in terms of either currency) have provided solace to both Japanese and EC policymakers, but there is no consensus that these trends will continue. Because the absolute value of exports to the EC is so much higher than that of imports from the community, Japan would have to buy significantly more than it sells to cut the trade surplus to a politically sustainable level. Even if the surplus continues to drift downward, the imbalance probably will remain of sufficient size to generate bilateral friction for years to come.

While Japan's surplus with the EC as a whole hit a peak in 1987 in yen terms and in 1988 in dollar terms, its surplus vis-a-vis individual EC members shows a more mixed pattern, reflecting various members' national trade policies and economic situations. Countries with tight import controls on major Japanese products (France and Italy, for example) generally have shown a fluctuating mix of surpluses and deficits with Japan. Countries with less rigid controls (especially West Germany, Great Britain and the Netherlands) have experienced a consistently large deficit with Japan, influenced by the strength of domestic demand. Britain's flat economic performance in 1989 and 1990, for example, resulted in a drop-off in purchases from Japan.

A breakdown of Japan's trade with the community by major product groups (Tables 3 and 4) points to the comparative strengths and weaknesses of the two competitors. In line with relative resource endowments, trade in food products leans heavily in the EC's favor, while the balance of trade in many manufactured goods leans toward Japan. The international competitive position of Japanese makers of computer equipment and other office machines, machine tools, industrial and consumer electronics goods, motor vehicles and precision equipment is clear from the large surpluses they have enjoyed vis-a-vis the EC. EC manufacturers have built a surplus in one area -- chemicals; this strength to a large extent reflects the EC's highly competitive pharmaceutical industry and the cost edge European producers have in plastics and other petrochemical derivatives.

Even though exports to the community still outweigh imports from it by a wide margin, import growth in the 1988-90 period was impressive, spanning both manufactured products and industrial and agricultural inputs. Purchases of EC-made manufactured products climbed from $15.2 billion in 1987 to $24.2 billion in 1989 -- a 59.7 percent gain that was in line with the 59.1 percent jump in imports of manufactures from the United States over the same time frame. The expansion picked up speed in 1990, with purchases rising 27.6 percent to $30.9 billion versus a 15.5 percent increase to $32.5 billion in U.S.-sourced goods.

Table 1: Japan's Trade with the European Community and Selected EC Members

(in millions of dollars and percent change)

	Exports		Imports		Balance	
	Value	Change	Value	Change	Value	Change
European Community						
1990	$53,510	11.7%	$35,063	24.6%	$18,447	-6.6%
1989	47,908	2.2	28,146	16.9	19,761	-13.3
1988	46,873	24.3	24,071	36.2	22,802	13.9
1987	37,693	22.9	17,670	26.3	20,023	20.0
1986	30,675	53.3	13,989	57.3	16,686	50.0
Great Britain						
1990	10,782	0.4	4,765	6.7	6,017	-4.1
1989	10,741	1.0	4,466	6.5	6,275	-2.5
1988	10,632	26.5	4,193	37.2	6,439	20.5
1987	8,400	26.4	3,057	-14.4	5,343	73.8
1986	6,647	40.7	3,573	96.6	3,074	5.8
West Germany						
1990	17,777	11.7	11,487	27.7	6,290	-9.2
1989	15,920	0.8	8,995	10.9	6,925	-10.0
1988	15,793	23.1	8,101	31.8	7,692	15.1
1987	12,833	22.5	6,150	43.1	6,683	8.2
1986	10,477	51.0	4,298	46.8	6,179	54.1
France						
1990	6,124	15.6	7,586	26.8	-1,462	489.5
1989	5,298	6.3	5,546	28.6	-248	**
1988	4,986	24.2	4,313	50.2	673	-41.1
1987	4,014	27.3	2,871	54.8	1,143	-11.9
1986	3,152	51.3	1,855	40.1	1,297	70.9
Italy						
1990	3,410	22.5	5,007	31.6	-1,597	56.1
1989	2,783	-0.0	3,806	31.6	-1,023	847.2
1988	2,787	32.5	2,895	35.5	-108	237.5
1987	2,103	22.1	2,135	42.8	-32	**
1986	1,723	54.3	1,495	42.4	228	240.3
Denmark						
1990*	883	16.5	1,046	-12.8	-163	-63.0
1989	758	-4.3	1,199	5.0	-441	26.0
1988	792	-13.6	1,142	21.0	-350	1196.3
1987	917	-7.3	944	20.9	-27	**
1986	989	30.5	781	34.9	198	10.6
Netherlands						
1990*	5,521	8.0	1,071	-4.5	4,450	11.5
1989	5,112	1.1	1,122	12.7	3,990	-1.7
1988	5,054	24.1	996	31.6	4,058	22.5
1987	4,071	24.8	757	31.2	3,314	23.5
1986	3,261	57.5	577	31.4	2,684	64.5
Spain						
1990*	1,895	-2.4	736	32.4	1,158	-16.4
1989	1,941	4.4	556	3.5	1,385	4.7
1988	1,860	38.5	537	50.4	1,323	31.2
1987	1,343	24.8	357	20.2	986	26.6
1986	1,076	77.9	297	-15.1	779	205.5
Greece						
1990*	746	29.1	145	-18.1	601	49.9
1989	578	28.2	177	29.2	401	27.7
1988	451	1.1	137	98.6	314	-16.7
1987	446	-20.8	69	-4.2	377	-23.2
1986	563	-2.4	72	14.3	491	-4.5

*January-November 1990; percentage change based on the same period of 1989.
**Meaningless.

Source: Ministry of Finance

Table 2: Japan's Trade with the European Community and Selected EC Members

(in millions of yen and percent change)

	Exports		Imports		Balance	
	Value	Change	Value	Change	Value	Change
European Community						
1990	Y7,732,983	17.6%	Y5,075,360	31.1%	Y2,657,623	-1.8%
1989	6,577,895	9.6	3,870,210	25.6	2,707,685	-7.3
1988	6,002,754	9.4	3,082,865	20.2	2,919,898	-0.1
1987	5,487,963	6.1	2,564,847	9.2	2,923,116	3.5
1986	5,173,677	8.5	2,348,282	10.4	2,825,395	7.0
Great Britain						
1990	1,562,177	6.0	756,426	23.4	805,751	-6.3
1989	1,473,087	8.2	612,966	14.3	860,121	4.2
1988	1,361,791	11.6	536,179	21.0	825,612	6.2
1987	1,220,781	8.7	443,096	-25.3	777,685	46.8
1986	1,122,837	-0.8	593,175	37.2	529,662	-24.3
West Germany						
1990	2,564,922	17.3	1,661,698	34.3	903,224	-4.9
1989	2,186,563	8.1	1,237,021	19.2	949,542	-3.7
1988	2,022,411	8.1	1,036,659	16.2	985,752	0.8
1987	1,871,028	5.9	893,045	23.1	977,983	-6.0
1986	1,766,215	7.3	725,473	3.7	1,040,742	10.0
France						
1990	885,982	21.8	1,098,417	44.2	-212,435	413.3
1989	727,250	13.9	761,886	37.8	-34,636	**
1988	638,717	9.4	553,056	33.0	85,661	-49.0
1987	583,796	9.7	415,691	33.4	168,105	-23.8
1986	532,272	7.4	311,671	-1.6	220,601	23.3
Italy						
1990	442,149	15.5	727,191	38.6	-285,042	101.2
1989	382,827	7.3	524,524	41.3	-141,697	876.7
1988	356,830	17.0	371,337	19.3	-14,507	138.0
1987	305,111	5.1	311,206	24.1	-6,095	**
1986	290,424	9.4	250,820	-4.7	39,604	196.9
Denmark						
1990*	128,432	23.1	153,318	-7.1	-24,886	-58.9
1989	104,353	3.1	164,972	12.6	-60,619	33.7
1988	101,232	-24.5	146,556	7.2	-45,324	1653.3
1987	134,066	-19.8	136,651	4.1	-2,585	**
1986	167,117	-8.2	131,250	-5.2	35,867	-17.6
Netherlands						
1990*	805,273	14.6	155,885	1.3	649,388	18.3
1989	702,786	8.6	153,840	20.6	548,946	5.6
1988	647,231	9.0	127,588	15.9	519,643	7.4
1987	593,779	8.2	110,053	13.0	483,726	7.1
1986	549,004	11.9	97,356	-7.5	451,648	17.2
Spain						
1990*	277,026	4.0	106,530	40.0	170,496	-10.4
1989	266,433	11.8	76,107	10.6	190,326	12.3
1988	238,320	22.3	68,832	32.7	169,488	18.5
1987	194,857	8.1	51,857	2.1	143,000	10.4
1986	180,282	25.8	50,804	-39.3	129,478	117.1
Greece						
1990*	108,630	36.6	21,297	-12.6	87,333	58.4
1989	79,516	37.8	24,376	39.4	55,140	37.2
1988	57,685	-12.2	17,490	71.6	40,195	-27.6
1987	65,709	-30.3	10,192	-18.0	55,517	-32.2
1986	94,271	-33.8	12,433	-20.7	81,838	-35.4

*January-November 1990; percentage change based on the same period of 1989.
**Meaningless.

Source: Ministry of Finance

Table 3: Japan's Dollar-Denominated Trade with the European Community by Product Group

(in millions of dollars; exports f.o.b., imports c.i.f.)

	1985	1986	1987	1988	1989	1990*
Exports						
Food	$72	$120	$152	$149	$150	$122
Textiles and Clothing	457	736	779	826	822	873
Chemicals	939	1,403	1,792	2,270	2,390	2,547
Pharmaceuticals	107	154	187	239	254	285
Plastics	175	281	335	447	492	534
Nonmetallic Mineral Manufactures	143	225	235	310	299	320
Metals and Fabricated Metal Products	544	738	723	958	1,096	1,102
Machinery and Transport Equipment	15,881	24,575	30,601	38,262	38,988	3,901
Power Generating Machinery	272	476	692	886	936	912
Computers and Other Office Machines	1,752	3,124	4,054	5,288	5,277	5,520
Machine Tools	340	535	591	722	897	946
Electric Power Machinery	163	248	318	460	448	428
Televisions	143	167	150	216	277	383
Radios	445	589	567	571	602	678
Electronic Tubes and Semiconductors	818	1,070	1,187	1,723	2,105	1,849
Motor Vehicles	3,039	5,225	6,944	8,496	8,436	8,539
Motorcycles	310	521	711	772	845	966
Precision Instruments	1,830	2,589	2,965	3,506	3,641	3,575
Other	1,980	2,879	3,411	4,097	4,164	4,281
Total	20,016	30,675	37,693	48,873	47,908	53,510
Imports						
Food	976	1,399	1,791	2,404	2,867	2,857
Textile Fibers	88	88	154	134	161	86
Metal Ores and Scrap	40	39	122	114	129	138
Mineral Fuels	80	192	104	154	201	168
Other Raw Materials	224	314	352	494	556	550
Chemicals	2,131	2,918	3,873	5,000	4,968	4,755
Pharmaceuticals	434	690	957	1,282	1,338	1,231
Machinery and Transport Equipment	2,339	3,677	5,445	7,138	8,635	10,963
Computers and Other Office Machines	83	121	180	209	254	270
Power Generating Machinery	90	113	174	165	177	195
Machine Tools	82	124	103	143	169	251
Aircraft	27	118	98	228	188	228
Precision Instruments	225	297	374	394	419	484
Others	3,014	5,361	5,828	8,632	10,630	12,575
Steel	49	94	89	186	148	169
Nonferrous Metals	233	259	381	892	788	704
Textiles and Clothing	672	943	1,307	1,762	2,417	2,794
Total	8,893	13,989	17,670	24,071	28,146	35,063

*January-November 1990.

Source: Japan Tariff Association

Table 4: Japan's Yen-Denominated Trade with the European Community by Product Group

(in millions of yen; exports f.o.b., imports c.i.f.)

	1985	1986	1987	1988	1989	1990*
Exports						
Food	Y17,287	Y20,170	Y22,109	Y19,135	Y20,617	Y17,810
Textiles and Clothing	107,994	123,732	112,959	105,731	113,065	127,597
Chemicals	223,944	236,613	260,645	290,377	328,012	372,731
Pharmaceuticals	25,374	26,050	27,180	30,530	34,901	41,348
Plastics	41,798	47,352	48,783	57,182	67,557	78,116
Nonmetallic Mineral Manufactures	34,156	38,132	34,160	39,712	41,144	46,621
Metals and Fabricated Metal Products	128,934	124,827	104,907	122,723	150,560	160,968
Machinery and Transport Equipment	3,784,420	4,145,875	4,457,740	4,900,063	5,351,821	5,694,728
Power Generating Machinery	64,849	79,986	100,357	113,391	128,076	132,709
Computers and Other Office Machines	418,380	523,706	588,320	677,876	727,170	805,950
Machine Tools	80,311	90,694	85,402	92,395	123,978	138,282
Electric Power Machinery	38,786	41,747	46,131	58,953	61,627	62,538
Televisions	34,060	28,167	21,780	27,636	38,246	55,671
Radios	105,784	98,657	82,658	73,382	82,984	98,847
Electronic Tubes and Semiconductors	196,600	180,135	172,074	220,647	289,523	270,655
Motor Vehicles	722,769	892,540	1,019,928	1,086,383	1,152,009	1,223,344
Motorcycles	73,873	89,885	103,840	98,083	115,033	140,640
Precision Instruments	433,968	436,151	430,826	449,227	501,203	521,649
Other	471,269	484,328	495,443	525,013	572,678	624,312
Total	4,768,004	5,173,677	5,487,963	6,002,754	6,577,895	7,732,983
Imports						
Food	232,134	235,493	259,643	307,898	395,795	415,946
Textile Fibers	21,153	14,840	22,552	17,127	21,899	12,567
Metal Ores and Scrap	9,713	6,710	17,660	14,573	17,780	19,967
Mineral Fuels	19,904	34,017	15,532	19,694	27,293	24,588
Other Raw Materials	53,701	53,497	51,241	63,204	76,254	80,165
Chemicals	511,285	492,075	562,756	640,703	679,453	695,285
Pharmaceuticals	103,869	116,043	138,933	164,319	183,152	179,726
Machinery and Transport Equipment	559,132	619,981	790,906	913,279	1,190,045	1,600,811
Computers and Other Office Machines	19,628	20,243	25,985	26,734	35,157	39,242
Power Generating Machinery	21,314	19,259	25,206	21,074	24,221	28,214
Machine Tools	19,563	20,660	15,040	18,241	23,185	36,479
Aircraft	6,462	20,791	14,166	29,261	26,010	33,488
Precision Instruments	53,445	50,183	54,441	50,453	57,682	70,579
Others	719,512	891,670	844,557	1,106,386	1,461,691	1,837,022
Steel	11,835	15,999	12,968	23,826	20,562	24,850
Nonferrous Metals	56,031	44,055	54,728	114,729	108,001	102,815
Textiles and Clothing	161,309	157,849	190,642	226,710	333,556	409,858
Total	2,126,894	2,348,282	2,564,847	3,082,865	3,870,210	5,075,360

*January-November 1990 only.

Source: Japan Tariff Association

More significantly, imports of some high-profile EC manufactured goods showed strong gains, with EC shipments of office machines, machine tools, precision equipment and aircraft breaking out of the narrow zones in which they had fluctuated during the mid-1980s.

Of course, the role of exchange rates in influencing trade flows cannot be ignored. The shifting value of the yen against major European currencies clearly amplifies or diminishes the value of exports, imports and the resulting trade balance. (The linkage by EC countries -- and soon Britain -- of their currencies within the European Monetary System, in which the Deutsche mark plays a major role, means that the yen moves in a similar direction against most European currencies.) Yet from this standpoint there is some reason for optimism. In both 1989 and 1990 the yen fell against the Deutsche mark (16 percent and 6.2 percent, respectively, based on a comparison of yearend rates); it also was lower against the British pound (1.2 percent and 11.4 percent, respectively). Nevertheless, this depreciation, which makes European goods more expensive from Japan's viewpoint, did not stunt Japanese imports from most EC countries. Imports in both years recorded very strong growth. The reasons for this impressive European export performance are not all clear; strong Japanese consumer demand for European luxury goods and cars is an oft-cited factor.

Rules of the Game - How the two sides have approached trade policy and bilateral trade negotiations is another study in parallels. In contrast to the United States, Japan's government and those of most EC members traditionally have played a major role in economic matters. In addition to providing indirect support to domestic businesses through strong social welfare spending (primarily health care and education), these governments for the most part have acted directly to promote specific industries via tax and trade policies as well as research and development expenditures. (Washington certainly engages in all these activities but to a lesser degree and not with such specificity.) In other words, economic policymakers in Japan and in many European countries accept industrial policy as a legitimate pursuit. Additionally, agricultural policy is important to both Japan and the EC, with the farm tradition occupying a special niche in their national psyches. More specifically, Japanese and European farmers are highly influential in national politics.

These similar activist attitudes make it no surprise that bilateral trade relations have been marked by numerous cases of direct government action. In the immediate postwar years Tokyo sought to protect Japan's war-ravaged industries by limiting imports of almost all manufactured goods; it also indirectly controlled import flows through a tight rein on foreign exchange transactions. These restrictions gradually were eliminated in the 1960s and the first part of the 1970s. Over the same period European discrimination against Japanese products also declined, but the process stopped far short of an open market, particularly in France and Italy. To this day both countries control imports of cars from Japan as well as a number of other products through formal agreements. France, Italy and some additional EC members also limit several other goods through voluntary restraint agreements. Every such arrangement has one purpose only: to protect weaker European companies from the competitive might of the Japanese.

Because the EC's basic function is to promote the health and well-being of its members, it has toughened its trade negotiating position as Japan and other countries have mounted competitive challenges in industry after industry.

The community has strong antidumping regulations and has shown that it is unafraid of using them; the list of Japanese products that have been or are the target of EC antidumping-duty penalties is not brief. The most recent addition is blank audio cassette tapes. The EC also has occupied itself uncovering "unfair" Japanese trade practices that might hurt EC exports or put European firms at a competitive disadvantage. Japan's differential tax on alcoholic beverages, which featured a steeper tax on high-quality beverages such as European liquor, essentially was eliminated in 1987 after a steady EC lobbying effort. Most recently, the community has launched an investigation into the structure of Japanese harbor charges after allegations from European shippers that they are charged more than Japanese boats for the same services.

This tough EC negotiating stance on trade suffered a setback in 1990 when a world trade body handed Tokyo a victory in its case against certain EC antidumping practices. In 1987 the EC extended antidumping duties on imports of finished goods to locally produced versions assembled from imported parts. The community argued that Japanese exporters were circumventing the duties placed on finished goods by setting up "screwdriver" operations in the EC. Tokyo charged that the EC practice violated the rules of the General Agreement on Tariffs and Trade and asked for GATT arbitration after bilateral talks failed to resolve the issue. A GATT panel agreed that the EC action contravened GATT rules; however, the community so far has blocked final adoption of the ruling and appears ready to defy its trading partners on this issue.

Trade disputes remain a constant feature of bilateral relations; negotiated settlements are the exception rather than the rule. Last year, though, Japan and the EC agreed to hold regular ministerial-level meetings to address bilateral trade issues -- a sign that both sides are assigning a higher priority to bilateral economic ties. But the new forum is not expected to stop the bickering, if anything it will intensify as the community grapples with its plans for 1992.

1992: New Opportunities and New Problems

The EC's economic integration plan is nearly all encompassing. Internal customs structures will be swept away and external customs structures will be harmonized and unified. Another goal of the plan is to create a single internal market by December 31, 1992 for all professional and financial services, while at the same time harmonizing the rules governing foreign activities in these areas. Intellectual property rights will become more uniform within the community. Industrial, safety and environmental standards also will begin to be harmonized. While monetary and fiscal policies will remain under the control of sovereign members, the tighter economic union eventually will force convergence of interest rate and tax policies. Preparations for a central EC monetary authority (analogous to the Federal Reserve Bank in the United States) are under way. To keep businesses from moving to another EC country governments are studying how to match each others' tax incentives and limit disincentives. This move undoubtedly will foster regulatory convergence, since such rules figure prominently in corporate evaluations of the local business climate.

Rulemaking Worries - The attraction to foreign firms of the EC's consolidation is obvious: the creation of a borderless consumer and industrial market some 320 million people strong. Although the EC steadfastly has stated that it does not intend to create a "fortress Europe" that will shut foreigners out

of its enlarged market, officials make no bones about drawing up rules that explicitly or implicitly acknowledge differences in how domestic and foreign firms are treated. In professional services, for example, EC members have agreed that mutual recognition of professional accreditations will be the general rule for domestic -- but not necessarily foreign -- practitioners. In fields such as legal services foreign professionals may be treated less generously after 1992 than before. But new opportunities may open for foreign-based firms in some areas. Particularly in financial services foreign companies will receive essentially the same treatment as their domestic rivals.

One worrisome trend for government and business in the United States and Japan is the EC's tilt toward reciprocal national treatment -- giving foreign firms the same treatment in the home market that domestic companies receive in foreign markets. Unilateral national treatment -- treating domestic and foreign firms uniformly at home regardless of how local companies are treated abroad -- is the preferred concept in Washington. The EC, however, has adhered to reciprocal national treatment as its basic approach to developing new business rules for 1992. The concept of reciprocity is theoretically attractive but often difficult to employ in the real world because of varying economic and regulatory structures. Both Tokyo and Washington are keeping a wary eye on how the community incorporates and implements this concept.

Nailing down the myriad details necessary to implement a true economic union stands out as a major challenge for the EC, one that its trading partners are watching carefully. Two-thirds of the roughly 280 proposed implementing directives have been enacted. The EC Commission develops these model directives, which, in turn, must be approved by member governments' own legislatures before taking efect. EC members have been especially slow to act on politically sensitive directives. Harmonizing value-added tax rules is a prime example of foot-dragging that threatens the 1992 plan. The EC Commission has chastised its members, saying that despite their unanimous commitment to harmonize VAT structures, "no precise measures have been taken" by any of the 12. Such indecision and sluggishness create uncertainties, an abhorrent situation to business planners. Some Japanese firms are postponing decisions regarding EC operations because they fear that making a choice now may be like building a house on shifting ground. One industry, in particular, highlights how this new problem can exacerbate a preexisting dispute.

The welcome extended to Japanese motor vehicle exporters by EC members ranges from open arms to closed fists. France, Italy and Spain impose very tight limits, Portugal and England less stringent ones. Germany and a few others have no restraints at all. The EC has been negotiating a unified position on Japanese car exports with both its members and Tokyo for more than a year, but a solution remains out of reach because of determined opposition from some members. The latest proposal would allow Japanese-made cars to capture as much as 18 percent of the combined EC market over five years beginning in 1993. A clause requiring cuts in Japanese exports in the event of a market downturn reportedly exists, however. In Japan's eyes this approach is an improvement over the hard-line French and Italian position of a 10 percent market share cap lasting 10 years but is worse than the shorter transition period advocated by the British and the Germans. Estimates put 1990 sales of Japan-badged cars at slightly less than 10 percent of the EC market; this rises to nearly 12 percent if trucks are included.

What also must be decided is how to treat vehicles assembled in the community by Japanese-owned subsidiaries or joint ventures with Japanese participation. Some members want all cars built by the Japanese to be counted, even Europe-bound vehicles produced in U.S. factories. Britain, where three major Japanese automotive makers have or are building production facilities, strongly opposes this position. While Tokyo reportedly has agreed to most points of the proposal, the Ministry of International Trade and Industry has said the inclusion of locally assembled cars in quota calculations is unacceptable. The EC Commission has threatened legal action against governments that continue individual car quota policies after 1992, but it is uncertain whether a uniform position can be hammered out that also would be acceptable to Japan.

Japanese motor vehicle manufacturers have resigned themselves to the political necessity of a voluntary restraint agreement. MITI has had talks with Toyota Motor Corp. (which has 2.6 percent of the EC market), Nissan Motor Co., Ltd. (2.7 percent), Mazda Motor Corp. (2 percent) and Honda Motor Co., Ltd. (1.1 percent) about the delicate situation. Some observers think these talks are a prelude to limited export growth to the EC this year and next, so as not to give EC protectionists added ammunition.

Moreover, Toyota is taking pains to develop local suppliers as it builds a factory in Britain. For its part, Nissan, which is introducing its first mid-size car specifically designed for the European market and built in Britain, plans to expand its British output gradually. The two largest Japanese automotive manufacturers also do not expect their luxury car models (marketed here under the Lexus and Infiniti nameplates, respectively) to make much of a splash in the European market. Mitsubishi Motor Corp., however, plans to begin raising its visibility on the continent, ironically by exporting the Eclipse sports coupe from its American factory; it also is seeking a partner to build a production facility.

Investment Worries - The mixed reaction to onshore Japanese car production spotlights another area of controversy: foreign direct investment. Although the United States continues to grab the lion's share of Japanese foreign direct investment (see Table 5), the rate of expansion of Japanese investment flowing into Europe has outpaced that headed toward the United States in recent years. Europe's share of annual Japanese foreign direct investment rose from 15.8 percent in FY 1985 to 21.9 percent in FY 1989. The United Kingdom has benefited the most, easily attracting more Japanese investment than any continental country and accounting for more than one-third of Japan's cumulative investment in Europe. The second- and third-place rankings for the Netherlands and Luxembourg are deceptive, since most Japanese investment booked in these two countries ultimately ends up elsewhere in Europe. The surprisingly low Japanese stake in Germany and France is thought to result primarily from investor concerns since both countries are putting out more of a welcome mat for Japanese investors.

The EC's discouragement of screwdriver assembly plants, however, indicates a more discerning attitude toward foreign direct investment than that shown by Washington, although the debate in this country over the economic value of investment from abroad hardly can be called settled. European governments are interested in promoting foreign direct investment for employment gains, increasing value-added output, the inward transfer of technology and the development of local suppliers. In support of these reasons the EC has tried to impose

Table 5: Japan's Foreign Direct Investment by Country, FY 1985-FY 1989

(in millions of dollars)

	FY 1988			FY 1989			Cumulative March 31, 1990		
	Cases	Value	Share	Cases	Value	Share	Cases	Value	Share
United Kingdom	211	$3,956	8.4%	285	$5,239	7.8%	1,864	$15,793	6.2%
Netherlands	105	2,359	5.0	112	4,547	6.7	642	10,072	4.0
Luxembourg	13	657	1.4	13	654	1.0	143	5,383	2.1
West Germany	67	409	0.9	119	1,083	1.6	1,053	3,448	1.4
France	148	463	1.0	168	1,136	1.7	1,157	2,899	1.1
Spain	32	161	0.3	58	501	0.7	277	1,546	0.6
Italy	26	108	0.2	47	314	0.5	255	684	0.3
Ireland	12	42	0.1	11	133	0.2	90	565	0.2
Portugal	4	7	0.0	10	74	0.1	44	114	0.0
Switzerland	27	454	1.0	19	397	0.6	288	1,829	0.7
Other Europe	47	500	1.1	74	730	1.1	656	2,639	1.0
Total Europe	692	9,116	19.4	916	14,808	21.9	6,469	44,972	17.7
United States	2,434	21,701	46.2	2,668	32,540	48.2	20,675	104,400	41.1
Hong Kong	335	1,662	3.5	335	1,898	2.8	3,499	8,066	3.2
China	171	296	0.6	126	438	0.6	694	2,472	1.0
Total	6,077	47,022	100.0	6,589	67,540	100.0	57,373	253,896	100.0

	FY 1985			FY 1986			FY 1987		
	Cases	Value	Share	Cases	Value	Share	Cases	Value	Share
United Kingdom	85	$375	3.1%	142	$984	4.4%	178	$2,473	7.4%
Netherlands	38	613	5.0	60	651	2.9	71	829	2.5
Luxembourg	12	300	2.5	16	1,092	4.9	18	1,764	5.3
West Germany	48	172	1.4	59	210	0.9	50	403	1.2
France	60	67	0.5	52	152	0.7	99	330	1.0
Spain	8	91	0.7	15	86	0.4	24	283	0.8
Italy	11	32	0.3	18	23	0.1	26	59	0.2
Ireland	5	81	0.7	4	72	0.3	5	58	0.2
Portugal	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Switzerland	15	60	0.5	7	91	0.4	22	224	0.7
Other Europe	31	139	1.1	31	99	0.4	44	71	0.2
Total Europe	313	1,930	15.8	404	3,469	15.5	537	6,576	19.7
United States	921	5,395	44.2	1,232	10,165	45.5	1,816	14,704	44.1
Hong Kong	105	131	1.1	163	502	2.2	261	1,072	3.2
China	118	100	0.8	85	226	1.0	101	1,226	3.7
Total	2,613	12,217	100.0	3,196	22,320	100.0	4,584	33,364	100.0

Source: Ministry of Finance

certain requirements on foreign-owned production facilities, mainly via discriminatory tariffs. For example, integrated circuits that do not undergo the high value-added production steps (wafer fabrication) in the EC are considered imports even if assembly and testing are conducted locally. This has generated a burst of investment announcements by Japanese chipmakers.

The EC's stance toward acquisitions by Japanese firms within its boundaries can best be described as one of vague unease. Under pressure from domestic firms the community has put forth a streamlined approval system for crossborder takeover bids. Whether foreign bids will receive the same treatment as domestic ones has not been discussed explicitly. American companies have pressed Washington to obtain assurances from Brussels on this question and appear to have received a mollifying response. For EC countries with a significant share of government-owned companies, such as France, the question of Japanese mergers and acquisitions is particularly sensitive. Chastened by the backlash created by takeovers of high technology companies in the United States, Japanese investors have approached this European minefield with particular care.

One Japanese investment, in particular, focused European attention on the subject. Fujitsu, Ltd.'s November 1990 purchase of 80 percent of British computer giant International Computers Ltd. for almost $1.3 billion stunned the continent. ICL was Britain's only remaining mainframe computer maker and a respected force in the European computer market. The buyout followed eight years of friendly relations during which Fujitsu provided much of ICL's mainframe technology. The purchase put Fujitsu in a close race with Digital Equipment Corp. for the number-two spot in the global information services market. The acquisition also gave Japan's top computer maker an enlarged presence in the European computer market. It is not a commanding position, however, as ICL's share of the European market is about 1.8 percent, tiny compared to the shares held by such U.S. firms as International Business Machines Corp. (20.1 percent) and DEC (4.5 percent). ICL's management touted the capital infusion as the key to expanding sales. Other European computer makers and some British observers viewed the transaction as an unpatriotic sellout. The acquisition has since triggered a European debate on an even more sensitive topic: Japanese participation in joint European research projects.

Research Fears - As Britain's leading computer maker, ICL was a member of several EC-funded and private research consortia. The company was a founding member of Esprit, for example, a roundtable of 12 European computer makers formed in the late 1970s to promote joint research and development in information technologies. At the time Fujitsu purchased its controlling share of ICL the British firm was involved in nine Esprit programs. In early February 1991, however, the managing board of Esprit voted to expel ICL, saying that its membership was no longer consistent with the roundtable's purpose of enhancing the competitiveness of the European computer industry vis-a-vis the Japanese and the Americans. ICL was not, according to Esprit, a "truly European-owned company." Fujitsu expressed regret at the decision but promised it would work to retain ICL's membership in other European projects. Fujitsu also announced plans to build its own research facilities in Europe to add to those owned by ICL.

One of the more visible EC-funded R&D projects is the Joint European Submicron Silicon Initiative or JESSI. ICL participates in five JESSI projects. Unfortunately for ICL, many Esprit board members also sit on JESSI's steering committee. A debate is raging over whether ICL's ties to Fujitsu can

somehow be turned to JESSI's advantage and whether EC funds should be used to support research by a Japanese-owned participant. ICL is hopeful that it will be allowed to remain in JESSI, pointing out that its involvement is more as a user of integrated circuits and that IBM's European subsidiary has been allowed to join two JESSI programs. A formal vote to expel ICL may be unnecessary because any EC-funded project must involve at least two partner firms. If ICL is unable to persuade another JESSI member to join in a program, it effectively may be barred from participation.

Another sensitive research project where the Japan question has surfaced in a different form involves development of the next generation of advanced televisions. Eureka, a joint research program started in 1985 aimed at developing commercial technologies (it oversees JESSI, for example), has put a high priority on a strong European presence in the market for high-definition television. Although Japan Broadcasting Corp. (NHK), a quasi-governmental company, had been working on HDTV since the 1960s, the Europeans managed to delay a 1986 vote on international standards that NHK had hoped to win. The Japanese firm had been ready to demonstrate its technology; its picture format and broadcast system already had been adopted as the future Japanese standard. The delayed vote of the global standards-setting body gave EC firms time to pool their resources to propose a different HDTV system. The United States since has weighed in with a third development effort and is about to begin a trial of several HDTV systems that are incompatible with both the Japanese and the European systems. (For a detailed discussion of the competition to develop advanced television, see JEI Report No. 2A, January 13, 1989.)

The EC continues to back Eureka's HDTV effort but may be foiled by unexpected developments. British, German and French television broadcasters are lukewarm about Eureka's system, arguing that it is too costly to install the necessary broadcast equipment. Resistance also has developed because the Eureka system is a transitional standard, not "true" HDTV. Promoters of the Eureka system ironically have turned to Japanese firms to help finance broadcast equipment installation in exchange for rights to produce the equipment. This would be a blow to France's Thomson SA, which has just brought to market a receiver compatible with the Eureka system. The $7,000 machine is considerably cheaper than what Japanese manufacturers are charging for their first-generation HDTV receivers.

The JESSI and Eureka research situations have brought the debate over Japanese participation to a boil, but a definitive answer has not yet floated to the top. Nevertheless, Japan and the EC have forged joint research ties in a number of important areas. For example, Britain's Rolls-Royce PLC and France's Snecma have agreed to participate along with United Technologies Corp. and General Electric Corp. in a Y5 billion ($37 million at Y135=$1.00) Japanese government-funded project to develop an engine for a Mach-5 aircraft. Along with the United States, the EC has responded with interest to a MITI proposal to develop standards for manufacturing technologies for future-generation products. Launching the Integrated Manufacturing System project has not been smooth (see JEI Report No. 37A, September 28, 1990) but does hold promise as a model for future cooperation.

Conclusion

It is clear that the emergence of Japan and the European Community as economic powers is forcing a reassessment of their bilateral relations. The

EC's 1992 economic integration plan poses huge challenges not only to the Europeans but to the Japanese as well. The implications and the effects of the 1992 plan cannot yet be fully predicted, if for no other reason than because many aspects of economic integration have yet to be completely worked out. At a minimum EC 1992 has underscored the woefully inadequate institutional framework for resolving bilateral disputes and has heightened the importance of developing such mechanisms. It also has highlighted the underdeveloped state of political relations between the two trading partners. Amicable settlement of relatively simple trade disputes has eluded the two sides, not boding well for the growing number of new, more difficult issues, such as direct investment policy and R&D policy. Bilateral relations probably will continue to exhibit a Jekyll and Hyde character for some time, as the two allies cooperate in some areas while battling each other furiously in others.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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